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## **Arizona's envious investment portfolio**

**The Treasurer's Office is often referred to as the state's bank. Tell our readers what that means.**

Basically every dollar that is collected by the state, whether it be sales taxes (every time you buy something you pay taxes), income taxes (every time you get a paycheck Uncle Sam takes his cut, so does the state of Arizona), to when you pay tax on your car, or you get a fishing license or any type of game license, or you buy something out of the vending machine in the basement of the Capitol. Every single source of revenue that comes through the state has to be deposited with us no matter where it comes from. We took \$36.54 billion in deposits last fiscal year.



**How much money is currently under management by the Treasurer's Office?**

About \$12.1 billion as of our October report.

**Does that amount — the approximately \$12.1 billion— remain relatively constant during the year, or are there fluctuations?**

There are seasonal fluctuations. Right now the state is spending money faster than it's coming in the door. We have about \$5.5 billion for the state government, about \$4 billion for local governments, and about \$2.6 billion for the state land trust endowment. The land trust [account] is growing. Local governments are depositing more money with us — that's a growing area, but the state is spending it faster than it's coming in, so that number's actually shrinking.

**Is that unusual?**

It's not unusual that we have fluctuations depending on time of year. We are going to see a larger spike in local government deposits not for any other reason than a lot of LGIP [Local Government Investment Pool] customers rely on property tax, and everybody is paying their property tax bills now, so we will see a spike in those property tax deposits, as well as from new depositors coming in. Likewise, on the state side, February is actually the month that sees the largest amount of state cash on hand. You say, "Why February?" Well, February is the month when the state receives all its sales tax monies from Christmas and holiday sales. You pay your sales tax when you go to the store in December, but the company doesn't remit that until the 20th of January, so it's sitting in the state's bank account in February. Also the first quarter estimated tax payment is in February. So, that's why February is always the flushest month of the year for the state.

**Now all of that money — the \$12.1 billion or however much is under your management at any one time — is all of that available for investment, and are there restrictions on who gets the income derived from those investments?**

It depends on where it came from. The proceeds or the profits or returns for those investments are given back to whoever gave us the money. We track about 1,800 funds for the state of Arizona. Of those 1,800 different funds and accounts, about 500 are allowed to earn interest. The investment proceeds of those 500 funds go right back in their fund.

As for the remaining state agency funds — that would be the remaining 1,300 to 1,400 — the actual number is always changing as state funds are created — we still invest those dollars, but it's the state general fund that gets the profits from those investments.

Regarding local government investors, it's dollar-weighted, so if a government unit had 10 percent of the total LGIP investment, they would get 10 percent of the profits or the returns off that investment. And then, for the state land trust endowment, we have 13 beneficiaries we track. Each one of those is invested separately even though we pool the endowment together. For example, the Common School Fund, which is the K-12 fund, has 87.6 percent of the money; so they are getting 87.6 percent of the returns out of the endowment proceeds.

**You've only been state treasurer for a year, but in comparison with your predecessors over the last 3 or 4 years, has the amount this office been able to earn for the general fund changed?**

Well, the markets are quite a bit different from last year. Last year was before the housing bubble hit, before we started seeing a downturn in everything else, so I was hoping that we would do just as well as they did last year with all of our improvements, knowing the fact that the economy was in worse shape. However, that is not what happened. We actually did better — a whole lot better.

In the first quarter of fiscal year '08 — that's July, August, September of this calendar year — we made \$143 million. The same period last year, they made \$108 million in what was a much, much better market to invest in. That's a 32.6 percent improvement, and this isn't just earnings — this is distributed earnings. There's a difference. Distributed earnings are monies that we've actually turned into hard cash and sent back out the door.

**Not paper profit.**

Not paper profit. These are real, hard profits. That was shocking to me when I heard those numbers. I thought, 'That can't be true. The markets are not as good as they were.' In fact, we had the whole credit crunch in August — right in the middle of that quarter — and, I said, 'We can't possibly have done that much better, because [investment managers] measure improvements in basis points, which are thousandths of a percent. Getting a whole percentage point improvement, much less 32 percent improvement, is just unheard of.' For the LGIP pools, it was 12.9 percent, because they are more limited in what they can invest in overall. But in the [land trust] endowment, it is 113 — 114 percent improvement.

**And what are the reasons for the improvement?**

A number of things have happened. First of all, when I got here in January, [the office] had been devastated by 162 percent turnover. They were down to one person in the trading room. We immediately tripled the trading room staff, and by giving them more people and more resources — even though the market was worse — they were able to dig deeper and go more farther and do more research. One person cannot possibly manage \$12 billion all by himself. It's just too big of a task, and so there is a lot of things you miss as a result of that. So, they're able now to go farther and find those deals that one person would not have had the time to get to.

The other aspect of this is my philosophy of "safety before liquidity before yield." We went through our entire portfolio starting in January and scrubbed the whole thing. Part of it was I had two portfolio managers we brought on. They had worked here before, but they hadn't worked here in the last four years, and [they needed to know] what we already own, so there's situational awareness.

And too, we wanted to scrub the entire portfolio to make sure we had no dogs left over from the previous administration — no landmines, no problems. At this point, now the housing bubble had burst, so we wanted to make sure we were not in a situation where we have any indirect connection with the sub-prime market.

We knew we didn't have any direct investments in sub-prime, but didn't know about indirect connections.

Let's go through and scrub the portfolio and make sure we're clean on all those areas.

They went through and not only looked at the securities themselves, but the actual assets that back them.

That's a level of due diligence that no one was doing in Wall Street at the time, so when August rolls around, and they have the big credit crunch, we're sitting on the portfolio that everybody else wishes they had.

We had already gotten out of things — Countrywide is probably a good example, but I can't take credit for it.

Tim [White] whom I promoted as CIO, had looked at Countrywide back in June of '06 and said, "We have too large of an exposure. This housing bubble's going to burst at some point. When it does, they are going to be impacted, because they are the largest lender." So, he started to reduce our exposure to Countrywide from \$146 million to, by the time I got there, less than half that. By the time August hit, we were down to just one small \$10 million bond, and it only had a few months to go [until maturity].

Our entire asset-backed commercial paper has been reduced from a high of about 18 percent down to about 1.2 to 1.3 percent. As a result, we moved our portfolio to a position that has been very well rewarded, because that's a portfolio that everyone else wants to get. So, that's part of why we've been able to do better.

[The recent problems in the market] have really been a good test of our strategy. We're seeing other states like Florida, Montana and Connecticut that are on the front page of the Wall Street Journal because of their problems, and people are talking about, 'Are they going to go under?' And school districts not being able to pay their teacher because they didn't follow the same guidelines we did. They started chasing yield, and

that's a good way to land yourself on the front page of the paper — start chasing yield.

We all remember Orange County, California, [which declared bankruptcy in 1995 as a result of an aggressive and risky investment strategy]. You don't chase yield in this business. That's for somebody else's portfolio. That's not what you do with tax payers' money. But, having said that, in this environment, chasing safety actually paid off in the long run. So, that gives you an idea of what the opportunity cost was with the previous administration. It's not that they lost money, but they lost a lot of opportunities, and that's unfortunate because right now I think the state could use a little extra money. We made \$732 million last quarter: \$480 of it was for state and local governments and \$267 million for the endowment.

**Are there any investment options that you are currently not permitted to participate in that you wish you were?**

We have two different types of investing that we do. Eighty percent of what we do is fixed income — bonds, primarily U.S. Treasuries and government agencies. Most of what we're doing is investing the float from the state and local governments. The government may not need the taxes it collects today until next week or next month or six months from now. So, we're essentially investing the float. Basically, we're investing the money in the checkbook. That's a different type of investment; it's much more short-term. It's a money market account type of investment. So, that's the reason why, in these types of investing, you're not going to change a whole lot, because of the [liquidity requirements].

The endowment is a little bit different. For the endowment, we're investing the proceeds from land sales, and we're never distributing the principal. Once we get a dollar in from a land sale, that dollar will be here forever; so we invest that dollar. We have a much different time horizon. Yield is more important.

For the other funds, our time frame is very short. We want a lot of liquidity, because you have to be able to cover payroll at the end of the week or pay for construction on that new firehouse or the school or whatever it is that you need. With the endowment, you are talking about never distributing those dollars, so it is a different type of investment there. Constitutionally we're allowed to invest in equities up to 60 percent. Right now, we have about 54 percent by market value in equities, but that's it. It's just fixed income equities. We are now looking at what places like Harvard and Yale are doing with their endowment investments. What are their good ideas? How can we appropriate some of their good ideas here?

We are looking at some further diversification. Right now, we're only looking at two asset classes: equities and fixed income. What about real estate? Every modern endowment portfolio includes a real estate component. We're in a different situation because we have 8.1 million acres of state trust land. Maybe we ought to start thinking about investing in real estate that we already own. We've got \$2.6 billion [in state trust land endowment]. We could take a small percentage of that to help improve the land we already own, so when it goes up for auction, it's worth even more. We can't lose money on it because even if it defaults, we get the land back. It's our land. If we're going to have a real estate portfolio, why don't we invest in land we already own? So, these types of things we're looking at right now, and that's going to be a longer process, so you'll see maybe a little bit this year from us and in future years. But, the endowment is a tremendous asset for the state that's not being utilized.

**What's the state treasurer's involvement in the state budget process?**

I sit as a statutory member of the Finance Advisory Committee. The FAC is a group of the best economists in the state and representatives from a few state departments and APS (because they know how many people are hooking up power, and they have an idea of growth). The purpose is to get together once per quarter and advise the Legislature on where we think the economy is going.

The Treasurer's Office hadn't really participated in the past. Now, we spend a lot of money to stay on top of where the markets are, where the economy is, and we spend a lot of our time on this because we're investing — we need to know where these things are going. So, we've been putting together information and providing advice as part of the Finance Advisory Committee.

We also created a new economic indicator — a leading economic indicator — based on some of our internal banking numbers, and we actually predicted this downturn back in the March meeting, before anyone else did. We actually started to see the downturn in our own numbers. Some of the economists were saying it as well. And we were trying to tell the Legislature last spring that the numbers are not coming in as good as they thought they were. We have to know how much on a daily basis we have to invest. And when we compared the daily cash balance year-over-year, we started to see that when the difference went below zero — in other words when we have less money-on-hand over a range of dates than the same dates the previous year — the economy was headed for a correction or recession.

Starting in January '07 all the way through today, we have been negative in year-over-year cash-on-hand every single month. Some of these months, we're negative 26 percent. Last month we were negative 16 percent. During last session's budget discussions, when [legislators] said, 'Oh, we're gonna get this \$150 million extra in new revenue,' we were saying, 'Absolutely not! You should be taking off \$150 million in revenue [from the forecasts] because we're not seeing it.' This cash-on-hand number is a real-time estimator of relative economic health. We were amazed at how well this correlated. This is a very good indicator from the Legislature's point of view as to whether or not they will have enough money to cover the budget they

passed, because if we're running negative in month-over-month cash on hand, there's a good chance we're heading for a deficit. They're following this indicator a lot closer now, because it has such a good track record. So, this is one of the things this office is trying to do

**If you were governor today, how would you solve the budget crisis?**

I went through this before when I was first in the Legislature. I was elected in 2000, got in 2001. Prior to 9/11, no one believed there was going to be a recession. The dot-com bubble was just that — it was the dot-com bubble — it didn't have any affect on Arizona. The fact that we have large tech industry here in Arizona was mostly ignored. No one wanted to believe there was a recession, so they just ignored it the first time. Of course, 9/11 happens, and everyone admits it. The next session was 2002. Well, 2002 was an election year, so no one wanted to cut or do anything or make the hard decisions in 2002, so they drained the Rainy Day Fund. They put in all the tricks and gimmicks and the borrowing. So, the '02 budget just covered up all the problems through the election, and then they came to '03, and that was the real mind-blower, because by the time '03 rolls around, now the problem's three years' delayed. And this is a true story: What [former Governor Hull] left on her desk for Napolitano was two bottles — one of them was a full bottle of aspirin; the other was an empty bottle labeled "Rainy Day Fund." We had a shortfall and no easy way to solve the problem. We're in the same situation now.

**Except the Rainy Day Fund is full.**

It's full now, but last year was the year they didn't listen to the numbers that showed we have a slowdown looming. They didn't really believe it. This year, do we use the Rainy Day Fund or do we address the fundamental problem? This is the same as '02 — we're in an election year, and the question is: 'Are we going to address the problem this year, or are they just going to cover it up and get through the election and then it's going to be miserable next year?' That's the real question.

My theory — my thought about it — is that when it comes to these budgets, if you need to cut a dollar today and don't do it, next year it becomes two dollars, because now you have two years' worth of deficits. Then by the third year — which is what's happening — it's now three times the problem. If you had just cut back spending the first year, you would not have to worry about it the next two. They were short \$250 million in last year's budget. That \$250 million that didn't roll in became a \$500 million problem in the '08 cycle. For the '08 budget, because they're still factoring in increased revenues that won't materialize, you're looking at a \$500 million shortfall, which also means it's \$500 in '09. Well, that's a billion dollars you gotta come up with just out of one \$250 million shortfall. That's the compounding effect.

This last budget grew long-term permanent spending by \$900 million. The total budget dollar amount didn't go up that much, but the operating budget went up \$900 million. If I were governor, I would say, 'Look, obviously everyone over-estimated revenues. That \$900 million of additional operating budget growth — we're not going to be able to do all that. We're going to install spending triggers so that as soon as that money comes in, those things automatically get funded.' You can cover up that \$900 million that we don't have with budget tricks, fund sweeps and borrowing. But once we get to a deficit of about \$1.2 billion, you're out of easy fixes, and the problem with the deficit right now is it's larger than \$1.2 billion. It's probably close to \$800 to a billion in '08, and then you've got the same problem in '09. And, this isn't going to be over by the time 2010 rolls around.

**Do things like borrowing for school construction and what you've called tricks and gimmicks and rollovers of some of the payments from one fiscal year to the next as a one-time fix, do they form any part of what you would recommend if someone would come into here from the Legislature or the Governor's Office and say, "Dean, what do we do?"**

Well, you roll back the growth that you put in last year that you didn't have, that never materialized. Essentially go back to the previous year's budget, and do things you have to do. You take care of formula growth with the Rainy Day Fund and use any of those other tools if you have to. You use that to cover the growth in areas that you have to cover growth for. That's what they're there for. They're intended to help you out, because the state continues to grow even though the revenues may not.

It's tough. It's not a simple thing to do. I also think we have to realize in Arizona that we are a boom and bust economy — we always have been. Look across the state. We are littered with ghost towns that built up in the boom that didn't plan for the bust, and guess what? They are a great place to visit now as an old ghost town. Arizona's always been like that. We need to start thinking much, much longer in our budget schedule, because if we don't, we're going to have the cycles that really are difficult to navigate.

**Would you like to explore the possibility of running for higher elective office someday?**

It's too early to talk about that. I'm just 11 months into my current office. I get this question all the time. Right now, I'm really enjoying this job. I think it's the best job in government. I don't collect taxes. I don't spend taxes. All I do is make money. It's the closest to running a business — because it really is — you're running a bank, you're running an investment shop. You're really an investment banker. It's just like being in the

private sector, so I'm enjoying this job. It's too early to even think about any of those things. We're just now really starting to get everything squared away and moving forward. We finished the clean up and the turn around of the office internally, and now we're trying to move forward on things to improve the office and help make the state more money, which they need. I wouldn't even think about what I am going to do in 2010 until the '08 election is over. We'll see what happens there first. But if you'd ask me two years ago if I'd think about running for treasurer, I'd have said, "No." A year ago, I'd have said, "No." I hadn't planned on running for treasurer, and that wasn't something I wanted to do or planned on doing, but I was asked to do it because of the problems [with the previous treasurer], so who knows what's going to happen? I'm just focused on doing my job.

But on your previous question, I thought of one other thing. I would not under any circumstances raise taxes because of this problem, including property taxes.

**Would you continue to cut taxes?**

If it were possible, but I don't think those bills are going to go anywhere anyway. That's not the focus right now, but I would not end the moratorium on the state equalization property tax. I think that would be a huge mistake right now. We saw 17 of 22 budget override elections fail at the last election. That has never happened in Arizona history. It would be front page news in the past if one or two out of 22 failed, much less 17. That is, I think, the public speaking loud and clear. They are upset at these property values and property taxes. If you start talking about re-implementing a property tax — a statewide property tax — right now, you're asking for a political backlash from the public like you've never seen. I think that would be a huge mistake. It shouldn't even be on the agenda.

I think the public is likely to say to the Legislature and governor, 'Well, you made this mess, you clean it up. I shouldn't have my property taxes go up to clean up the mess you made.' So I think that's one area that should be completely off the table, because the public doesn't want it. I wouldn't want it personally. I know there are discussions on both sides of that issue. You've got some talking about re-instating it, and some wanting to get rid of it entirely. I tried to do that last year. Unfortunately, we could only get agreement for the three year [suspension], but it really should be made permanent.

**Very good. I appreciate your time this afternoon.**

No problem.

By Barry Gartell